TABLE I-3. CURRENT INDICATORS OF BUSINESS FIXED INVESTMENT AND SURVEYS OF CAPITAL SPENDING PLANS FOR 1987

			1986				1987	
	1985	1986	I	II	III	IV	I	II
Current Indicators								
Real Nondefense Capital Goods Orders (billions of 1982 dollars per month)	29.8	30.1	29.4	28.9	30.4	31.8	30.1	32.9
Manufacturers' Capital Appropriations (billions of dollars, quarterly rate) a/	27.2	21.4	23.4	20.0	20.2	22.1	23.0	n.a.
Capacity Utilization (percent)	80.4	79.4	80.0	79.2	79.1	79.3	79.6	79.6
Corporate Economic Profits (billions of dollars, annual rate) b/	278	284	288	282	286	281	294	n.a.
Corporate Cash Flow (billions of dollars, annual rate) c/	369	375	382	375	377	368	367	n.a.
Corporate AAA Bond Rate (percent)	11.4	9.0	9.6	9.0	8.8	8.7	8.4	9.2
Standard and Poor's 500 Stock Index (annual percent change)	16.4	26.5	55.5	43.1	1.0	4.3	72.6	21.6

Surveys of Capital Spending Plans for 1987 (Percent Increase) d/

	Nominal	Real
Department of Commerce	3.1	2.8
McGraw-Hill	3.3	0.0

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; McGraw-Hill, Inc.; Conference Board; Federal Reserve Board.

NOTE: n.a. = not available.

a. Because of the seasonal adjustment, the annual figure does not equal the average of the quarterly figures.

b. Economic profits are adjusted for inventory valuation and capital consumption allowances.

c. Corporate cash flow is the sum of undistributed profits with inventory valuation adjustment and capital consumption adjustment (CCA) plus capital consumption allowances with CCA.

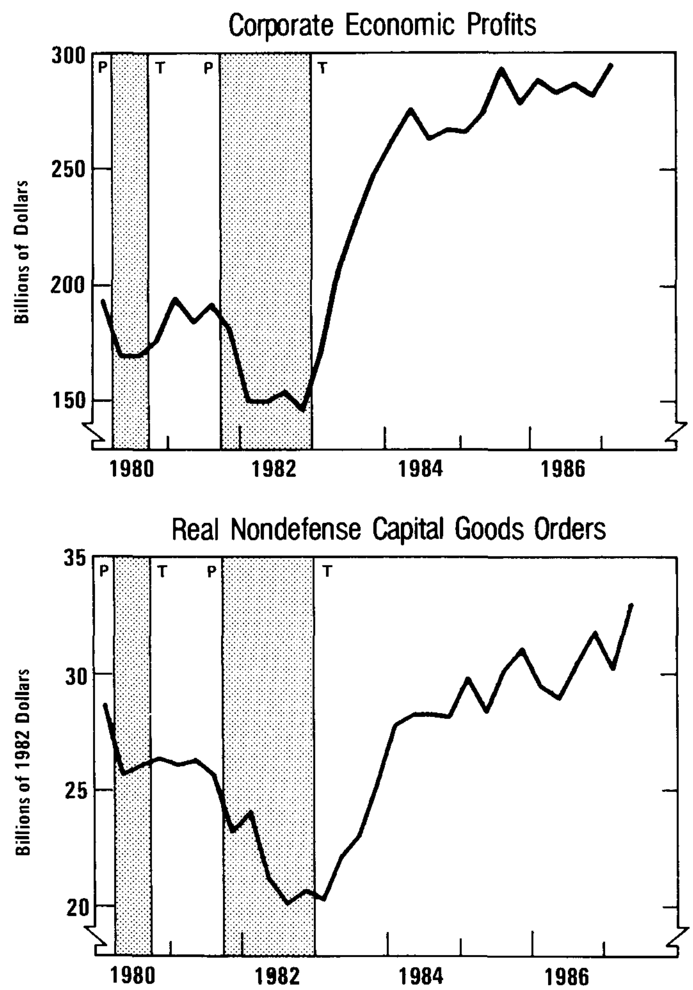
d. Conducted in April and May 1987.

Surveys of capital spending plans also suggest that a mild turnaround may be at hand. The most comprehensive survey available, conducted by the Commerce Department, shows an increase of 3.1 percent in nominal capital spending in 1987 compared with 1986. Using an extrapolation of recent price trends, the Commerce Department reports the expected increase in real terms to be 2.8 percent. Another survey, conducted by McGraw-Hill, shows a nearly identical rise in nominal spending. These surveys tend to be reliable indicators unless actual sales differ sharply from those expected at the time of the surveys.

Consumption

Growth in consumption spending has been strong for the past four years, and from 1984 to 1986 it outpaced GNP. This pattern is not common in an

Figure I-10.
Business Fixed Investment Indicators



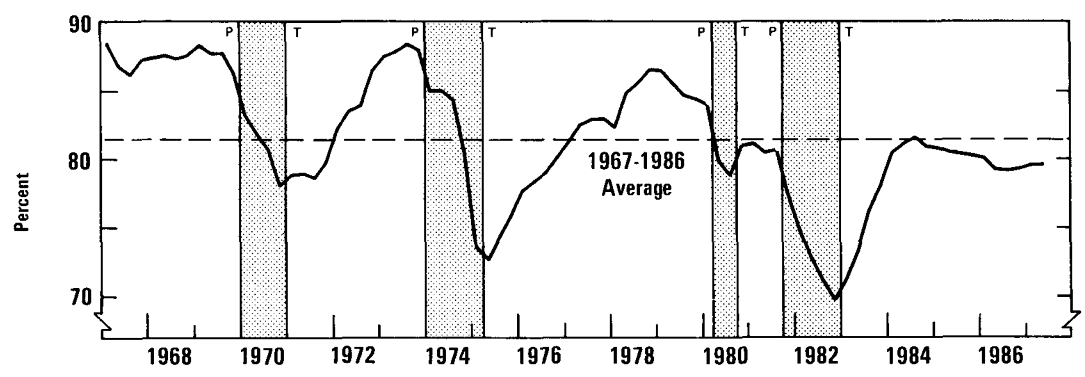
SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

expansion when other components of demand (especially investment) usually lead growth. From 1982 to the middle of 1986, consumption was sparked by growth in real income and declining interest rates; the latter not only lowered the costs of financing purchases of durable goods but also increased consumers' net worth. Growth in real income was strong largely because of the relatively slow rate of inflation. Prices of petroleum products and food fell, and, through early 1986, prices of imported goods grew very slowly. Consumption began to outpace income, however, and the personal saving rate fell from late 1984 to the present (see Figure I-12).

Beginning in the fourth quarter of 1986, however, consumption growth slowed considerably. Spending on nondurable goods weakened and purchases of durable goods fell sharply. Though some of the decline in durables was temporary--a result of changes in the sales incentives for autos, along with tax considerations--the overall trend over the last three quarters for both durable goods and total consumption has been toward slower growth.

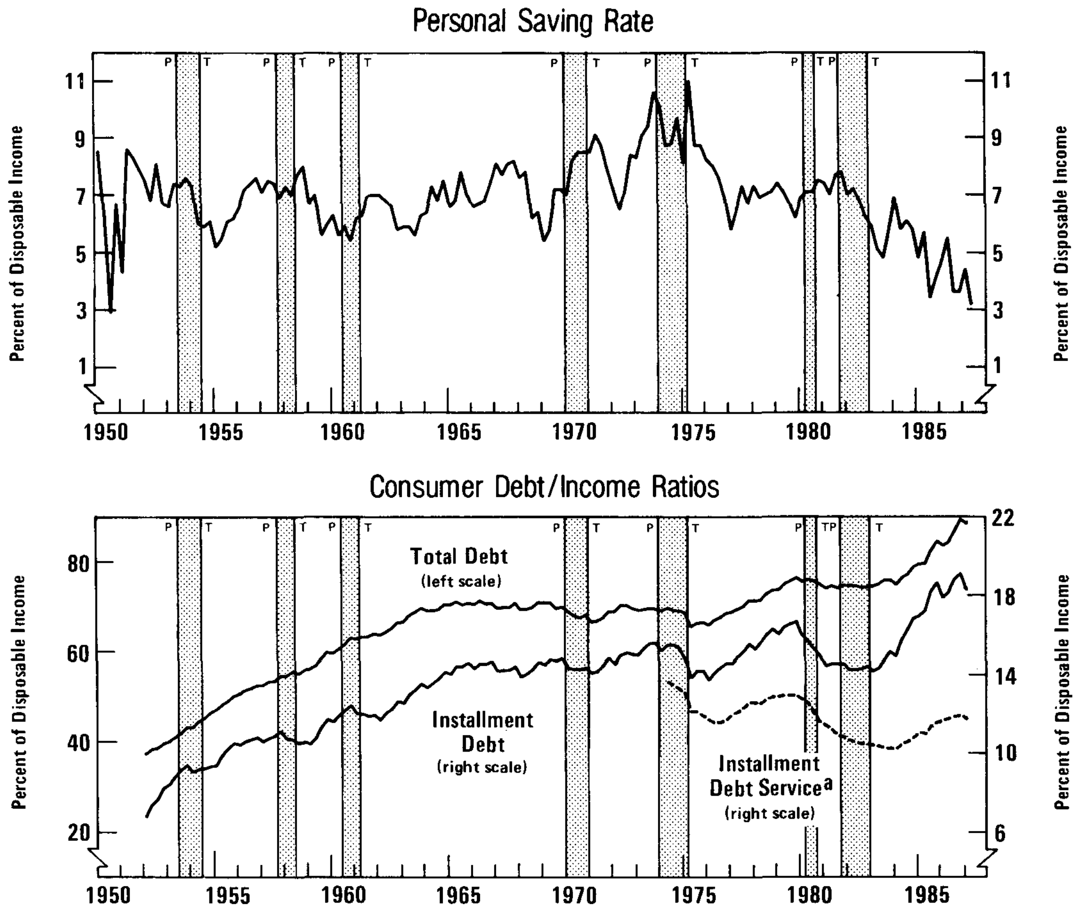
The main cause of the slowdown in consumer spending is low growth in real disposable income. In late 1986 and early 1987, labor incomes posted only moderate gains while inflation increased because of sharp increases in prices of petroleum products, apparel, and services. The net effect of these two factors was low growth in real personal income for the first half of 1987. In addition, two temporary factors reduced reported disposable income in early 1987: an increase in capital gains tax payments; and transi-

Figure I-11.
Capacity Utilization



SOURCES: Congressional Budget Office; Federal Reserve Board.

Figure I-12.
Saving and Debt Measures



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Goldman-Sachs.

[a]Required principal plus interest payments for installment debt. Estimated by Goldman-Sachs.

tory changes in agricultural subsidies. Because these factors are temporary, their combined effect on consumption was probably not large. They merely produced a temporary reduction in saving. 9/

The low personal saving rates of the last few years were associated with an increase in debt, which has raised concern over the financial health

9. The Tax Reform Act of 1986 reduced personal taxes (other than capital gains taxes), but these gains in disposable income were more than offset by inflation in the first half of 1987.

of the household sector. 10/ Total debt of the household sector as a percentage of disposable income has risen dramatically since 1982, and is at an all-time high (see Figure I-12). But the increase in debt is mitigated by several factors:

- The run-up in total household debt was more than matched by increases in the value of assets held by the household sector, particularly homes and corporate equities. Specifically, the net worth of the household sector increased 39 percent between the fourth quarter of 1982 and the fourth quarter of 1986.

- The ratio of installment debt service to income, according to calculations by Goldman-Sachs, is still below that of the late 1970s. This indicates that cash flow is not severely restricted. 11/

- Delinquency rates on consumer loans have fallen in the last year to their lowest levels since the early 1970s.

These factors indicate that the debt burden under existing circumstances is not excessive, although the size of the debt reduces the likelihood of rapid consumption growth in the near future.

The main determinant of consumer spending in the near term will probably continue to be real income. Real disposable income growth is not expected to be strong. Moreover, higher interest rates will raise consumers' cost of borrowing, and may also adversely affect future gains in the stock market. As a result, it seems likely that consumption will grow somewhat more slowly than disposable income between the third quarter of 1987 and the end of 1988, reversing recent trends and raising the saving rate slightly.

Residential Construction. Total housing starts have trended downward since early 1986, except for a brief surge in the first quarter of this year (see Table I-4). Much of the slowdown was caused by a slump in multifamily housing starts, which by the middle of 1987 had fallen to a pace less than two-thirds that of the first quarter of 1986. Contributing to the sluggishness in multifamily starts in the last half of 1986 were rising vacancy rates

10. Other measures of the personal saving rate, such as those that treat purchases of durables as an investment, or include corporate retained earnings and contributions to state and local pension funds, have also showed a downward trend over the last few years.

11. Mortgage interest rates over the last year have been at their lowest levels since 1978, suggesting that mortgage debt service--the major component of household debt--is also not excessive.

and the new tax law, which provides less favorable treatment of income from rental property not in service by the end of last year (see Figure I-13).

Single-family starts, on the other hand, fluctuated in response to movements in personal income and interest rates. The average interest rate on 30-year fixed-rate mortgages fell to its lowest level in nearly 10 years. This drop led to a surge in single-family starts in the first quarter of this year. In the second quarter, however, interest rates turned up sharply and personal income gains slowed, pushing single-family starts down again.

TABLE I-4. HOUSING

	1986				1987	
	I	II	III	IV	I	II
Starts (millions)						
Single-family	1.23	1.22	1.15	1.16	1.26	1.14
Multifamily	0.71	0.66	0.61	0.54	0.54	0.47
Total	1.94	1.88	1.76	1.70	1.80	1.61
Sales (millions)						
New	0.79	0.79	0.69	0.71	0.72	0.68
Existing	3.30	3.48	3.59	3.89	3.62	3.62
Total	4.09	4.27	4.27	4.60	4.34	4.30
Mortgage Interest Rates (percent) a/						
Thirty-year fixed-rate	10.56	10.26	10.24	9.67	9.11	10.32
One-year adjustable rate	8.87	8.56	8.38	7.90	7.58	7.81
Affordability Index b/	0.93	0.93	0.91	0.93	0.97	0.91

SOURCES: Congressional Budget Office; Federal Home Loan Mortgage Corporation; Department of Commerce, Bureau of Census.

a. Average contract rates of interest on conventional mortgage loans with loan-to-value ratios of 80 percent at major lenders surveyed weekly by the Federal Home Loan Mortgage Corporation.

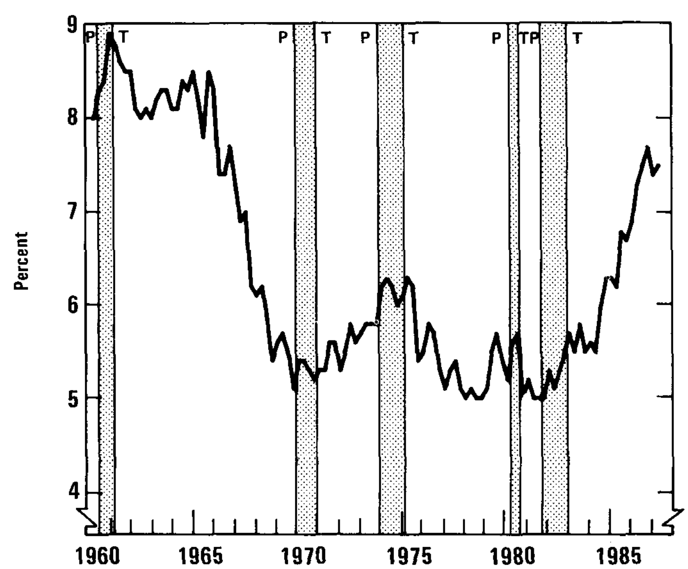
b. An affordability index of 1.00 implies that a median-income household could finance the median-priced home. An increase in the index means that homes are more affordable. Calculated by the Congressional Budget Office.

Total home sales trended upward through the first quarter of this year, reflecting the climb in the affordability index to its highest level in over eight years. (The affordability index measures the ability of the median-income household to service the mortgage loan needed to purchase the median-priced house.) Increasing interest rates, relatively slow gains in income, and a rise in house prices have reversed the rise in affordability, however, and home sales and housing starts fell in the second quarter and are expected to decline over the remainder of this year and most of 1988.

The Public Sector. In 1986, after increasing steadily for four years, the growth rate of real purchases by the public sector declined on a National Income and Product Accounts basis (see Table I-5). Despite some acceleration in the first half of 1987, very little growth is expected during the forecast period, as both federal defense purchases and state and local construction spending are expected to fall.

The growth of real federal purchases (excluding the activities of the Commodity Credit Corporation) declined in 1986, because of a slowing in the growth of defense spending (especially durable goods) and a decline in the level of nondefense purchases. During the first half of 1987, defense spending picked up, but federal purchases are projected to fall during the forecast period, reflecting the policies of the Budget Resolution for 1988.

Figure I-13.
Vacancy Rate for Rental Units



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Census.

Following steady increases in growth rates from 1981 through 1986, real purchases by state and local governments have exhibited a lower rate of growth thus far this year. This deceleration reflects in large part a slowdown in construction spending from the extraordinary pace of last year. With passage of the highway and clean water bills, some growth in construction spending is expected during the remainder of 1987, but this growth is expected to be followed by a decline during 1988. Other state and local spending should continue at a modest pace.

TABLE I-5. GOVERNMENT PURCHASES OF GOODS AND SERVICES (By calendar year, on a national income accounting basis)

	1985	1986	1986 I	1986 II	1986 III	1986 IV	1987 I	1987 II
				In Billions of 1982 Dollars				
Federal a/	312.0	324.7	314.6	325.0	333.3	325.8	329.8	335.4
Defense	236.7	250.7	240.0	250.1	259.8	252.7	257.4	262.4
Non-defense a/	75.3	74.0	74.6	74.9	73.5	73.1	72.4	73.0
State and Local	402.7	422.1	415.5	421.0	424.6	427.1	432.3	435.9
Structures	48.3	54.4	52.9	54.9	55.2	54.5	56.7	57.1
All other	354.4	367.7	362.6	366.1	369.4	372.6	375.6	378.8
				Percent Change (Annual Rate)				
Federal a/	6.5	4.1	-2.5	13.9	10.6	-8.7	5.0	7.0
Defense	8.3	5.9	-1.8	17.9	16.4	-10.5	7.6	8.0
Non-defense a/	1.1	-1.7	-4.7	1.6	-7.3	-2.2	-3.8	3.4
State and Local	4.1	4.8	7.1	5.4	3.5	2.4	5.0	3.4
Structures	6.4	12.6	34.7	16.0	2.2	-5.0	17.2	2.9
All other	3.7	3.8	3.7	3.9	3.7	3.5	3.3	3.5

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

a. Excludes purchases and sales by the Commodity Credit Corporation.

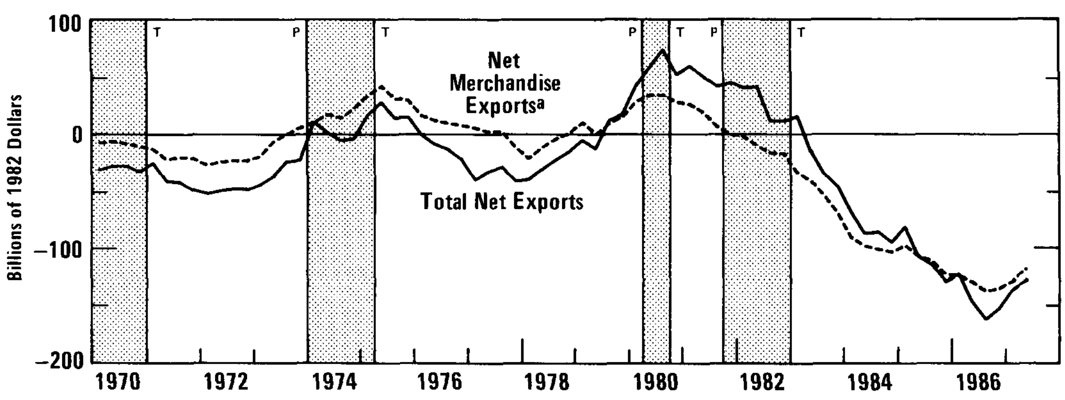
The budgets of state and local governments (excluding trust funds) registered a deficit of $9.1 billion in the first quarter of 1987--the first significant deficit in four years and the largest since 1975. Moderate deficits are expected throughout the forecast period, despite some windfall revenues from the Tax Reform Act of 1986, some increase in federal grants, and indications that many states plan to raise taxes. Trust-fund surpluses should continue to rise gradually, but the overall surplus of state and local governments will not provide as much offset to the federal deficit as in the recent past. Overall, however, the public-sector deficit is forecast to decline.

Net Exports

The long-awaited trend toward smaller real trade deficits appears to have begun. On a National Income and Product Accounts basis, real net exports improved by almost $35 billion in the last three quarters. Though much of the improvement in the last quarter of 1986 and the first quarter of 1987 resulted from sharp reductions in petroleum imports that are not expected to recur, gains were also registered in the real nonpetroleum, nonagriculture merchandise trade balance (see Figure I-14).

Nonpetroleum import prices have not increased as much as would be expected given the magnitude of the dollar's depreciation over the last two years (though sharp increases in import prices are expected soon). The

Figure I-14.
Real Trade Balance



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

[a]Nonpetroleum, nonagricultural merchandise.

anticipated fall in the growth rate of real imports is unlikely to occur unless inflation in import prices increases.

In contrast, the price movements that have already occurred imply a strong growth in real exports. Foreign currency prices of U.S. nonagricultural exports have fallen much more than the dollar prices of U.S. nonpetroleum imports have risen. This trend implies that even if the growth in imports is not slowed, a significant improvement in the real trade balance may occur because of strong growth in exports.

U.S. exports may be hampered by slow economic growth overseas. Forecasts for the major foreign industrial countries have been lowered in recent months, and their combined output--weighted by their shares in U.S. nonagricultural exports--is now expected to grow about 2.2 percent in 1987 (down from 2.7 percent in 1986) and about 2.5 percent per year over the medium term. Washington has not been successful in persuading other industrial countries to adopt more expansionary fiscal policies, except possibly in the case of Japan. 12/ On average, real growth in the developing countries and newly industralized countries, which is important for U.S. exports, is expected to be higher than in the developed world. For developed and developing countries together (weighted by U.S. nonagricultural export shares), growth is expected to be about 2.7 percent in 1987 (compared with 2.8 percent in 1986). Over the medium term, the aggregate foreign growth rate is assumed to be about 3.3 percent per year. The CBO forecast also assumes that inflation in foreign industrial countries will rise only moderately, and that the dollar will continue to depreciate in real terms against the currencies of developing and newly industrialized countries.

Weak agricultural exports and a surge in petroleum imports were a major cause of the deterioration in the trade balance through the third quarter of last year. These sectors are not expected to show further significant deterioration over the next 18 months, however. The outlook for agricultural exports has improved because of the fall in the dollar and drastic cuts in agricultural support prices made last year. In both nominal and real terms, agricultural exports are expected to grow strongly over the forecast horizon.

U.S. inventories of petroleum and petroleum products grew rapidly during the second and third quarters of 1986. After the inventory building stopped, oil imports fell sharply. Lower oil imports accounted for about $9

---

12. Prime Minister Nakasone recently announced a stimulus package, which, at a rate of 150 yen to the dollar, is equal to $33.3 billion in extra spending and $6.7 billion in tax cuts.

billion of the improvement in real net exports in both the fourth quarter of 1986 and the first quarter of 1987. Inventories have been drawn down from their late 1986 levels, but real oil imports are expected to increase at only a moderate rate over the next year and a half.

The balance of payments has been helped in the past by an excess of income on U.S. investments abroad over income on foreign investment in the United States. The balance on these factor service flows is expected to deteriorate significantly in both nominal and real terms over the forecast horizon because of the increase in net U.S. liabilities to foreigners. The net corporate profit component of investment income will probably decline only slightly, but the huge increase in net U.S. indebtedness will cause the net interest payment component to worsen precipitously.

Total real net exports should improve by about $30 billion between the second quarter of 1987 and the last quarter of 1988 because of strong growth in nonagricultural merchandise exports and slowing growth in nonoil merchandise imports. Most of the net export improvement will come from strong growth in nonagricultural merchandise exports, but the growth rate of real merchandise imports is also expected to decline from 13 percent in 1986 to about 2 percent in both 1987 and 1988. The real balance on factor service flows, as noted above, is expected to deteriorate throughout the forecast period, even though the balance on flows of services other than investment income (that is, transportation, tourism, insurance, and so forth) should improve substantially.

THE ECONOMIC FORECAST AND MEDIUM-TERM PROJECTIONS

CBO's economic projection has two parts: a short-term forecast of economic conditions through 1988, which is contingent on specific policy assumptions; and a medium-term projection through 1992 based on historical trends and other assumptions about economic growth.

The Short-Run Forecast

The forecast is for continued moderate expansion over the next 18 months at a rate slightly above that of the past year. The forecast is based on the following assumptions:

- *Fiscal Policy.* Federal tax and spending policies are assumed to be consistent with the budget resolution for fiscal year 1988.

This marks a change from the January report, which assumed that fiscal policy satisfied the requirements of the Balanced Budget Act. As a result, the fiscal contraction assumed to occur between fiscal year 1987 and fiscal year 1988 is substantially smaller than that assumed last January.

- *Monetary Policy.* The Federal Reserve is assumed to be constrained by its concern that the temporary bulge in price increases this year should not become the base for a renewed inflationary spiral. This concern suggests that the Federal Reserve will try to prevent further sharp depreciation of the dollar. International interest-rate differentials will therefore be a major concern of Federal Reserve policy.

- *Exchange Rates.* The large nominal trade deficit should continue to exert downward pressure on the dollar, and it is assumed that although the Federal Reserve will be successful in its effort to prevent the dollar from falling too rapidly, the dollar will depreciate by about 5 percent against the currencies of the major industrial countries over the forecast horizon.

- *Prices.* The refiners' acquisition price of imported oil is assumed to rise gradually to about $20 per barrel by the end of 1988. Food prices are assumed to rise at about a 4½ percent rate until the end of 1988.

Given these assumptions, real GNP growth is projected at 3.1 percent in 1987 and 2.6 percent in 1988 (fourth quarter to fourth quarter), as shown in Table I-6. The forecast for 1987 is virtually unchanged from that made in January, and the 1988 figure is slightly below that of January.

Prices. The dollar has fallen sharply and the world price of oil has risen since the January forecast was prepared. Because of these developments, the CPI is expected to rise a little more than 5 percent in 1987 and 1988 (fourth quarter over fourth quarter). These inflation rates represent an increase over the January forecast of more than half a percentage point in both 1987 and 1988. Because this inflation is primarily driven by import prices, the GNP deflator is expected to rise more slowly than the CPI, at around 4 percent in both 1987 and 1988 (fourth quarter over fourth quarter).

Income Shares. The Department of Commerce revised its estimates of income for 1986 and the first quarter of 1987 significantly in its recent release of the National Income and Product Accounts. Corporate profits were revised down by about $40 billion in the first quarter of 1987. Personal interest income was revised upward by about $30 billion, and farm income (excluding subsidies) and wage and salary disbursements were each revised upward by about $20 billion. These revisions in personal income assign a larger proportion of personal income to components that generate relatively low tax collections and also--by many estimates--less consumption.

Wage growth is expected to be moderate for the rest of 1987 and 1988--faster than the GNP deflator but slower than the CPI. CBO does not expect a price-wage spiral to develop. For 1987 and 1988, the share of wages and salaries in GNP should remain close to its 1986 level.

Other taxable income, which includes personal interest income, dividends, and proprietors' income, is expected to rise at about the same rate as GNP, keeping its share of GNP relatively flat for the short-term forecast.

TABLE I-6. THE CBO FORECAST FOR 1987 AND 1988

	Actual		Forecast	
	1985	1986	1987	1988
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	6.6	4.5	7.2	6.8
Real GNP	3.3	2.2	3.1	2.6
Implicit GNP Deflator	3.2	2.2	4.0	4.2
CPI-W a/	3.3	0.9	5.1	5.2
Calendar-Year Averages (percent)				
Unemployment Rate	7.2	7.0	6.3	6.1
Three-Month Treasury Bill Rate	7.5	6.0	5.9	6.6
Ten-Year Government Bond Rate	10.6	7.7	8.1	8.5

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

a/ Consumer Price Index for urban wage earners and clerical workers.

Corporate profits are expected to grow moderately over the next 18 months. Rising import prices will allow firms to rebuild their profit margins, but at the same time higher interest payments should cut into profits. As a share of GNP, therefore, profits are expected to remain roughly flat over the period of the short-term forecast.

Financial Markets. The Federal Reserve will probably seek to moderate further depreciation of the dollar. To do so, it will need to keep interest-rate differentials wide enough so that foreigners will continue to finance the large current account deficit by acquiring more dollar-denominated assets. Both short- and long-term rates increased in the first half of this year. Short-term rates are expected to continue to increase through the beginning of 1988, and decline thereafter. Long-term rates are expected to remain near their current levels to the end of 1988.

Aggregate Demand. The outlook for aggregate demand in the short term does not support a forecast of strong growth. Although real net exports are likely to improve, and the investment anticipations surveys point to a recovery in business fixed investment, the other major categories of final demand will be weak in real terms. Consumption expenditures are expected to slow, reflecting weak growth in real incomes of consumers, and federal spending on goods and services will be restrained by efforts to reduce the deficit. State and local government purchases are also expected to grow more slowly than GNP, while residential investment is likely to be adversely affected by tax reform and the recent rise in interest rates.

Uncertainties. Economic forecasts are always uncertain, and errors in the economic forecast are an important source of errors in the forecast of the federal deficit. Chapter III examines CBO's economic forecast record and the extent to which errors in forecasts have affected the deficit forecasts.

It is impossible, of course, to foresee the precise nature of errors in the current forecast, which does not differ substantially from those of other forecasters. However, some possibilities are of special concern:

- *Import Prices.* The massive dollar depreciation of the past two years has not yet been fully reflected in import prices. Moreover, the foreign exchange value of the dollar could change rapidly and unexpectedly. The rate of increase in import prices could be greater than that embodied in the forecast, and therefore inflation could be higher than indicated.

- *Slow Improvement in Trade.* The forecast for growth in demand relies heavily on improvements in net exports which are notoriously difficult to predict. The Federal Reserve may be faced with a dilemma if real net exports do not continue to improve: either to allow the economy to slide into a recession, or to abandon its attempts to prop up the dollar and risk another round of rapid dollar depreciation that could also be the precursor of even greater inflation.

- o *Oil Prices.* Concern over the very tense situation in the Persian Gulf has already shown up in a sharp rise in oil futures. A continuation or escalation of tensions in the Gulf could lead to higher oil prices and hence higher inflation and lower real income growth than are currently forecast.

- o *Consumer Spending.* The consumer could cut back sharply in response to increased inflation and interest rates, or to a decline in the stock market.

Medium-Term Projections

CBO's medium-term economic projections for the period from 1989 through 1992 are presented in Tables I-7 and I-8. Real GNP is projected to grow at an average annual rate of about 2.7 percent over the period, and the civilian unemployment rate to fall to 5.7 percent by 1992. The inflation rate (as measured by the GNP deflator) is expected to remain at the pace forecast for 1988, and interest rates are assumed to be close to current levels. Projected growth rates in real GNP and the GNP deflator for the 1989-1992 period are slightly lower than were projected in January, while interest rates and the growth in the CPI are somewhat higher.

These values are projections rather than forecasts in that, to a substantial degree, they simply reflect historically normal values and relationships among economic series. The methods used to make these projections are described below.

Real Output. Real gross domestic product (GDP) is used for making medium-term projections. 13/ It is preferred to the GNP measure because GDP relates more closely to employment and federal revenues. To arrive at the projection of real GDP, it was assumed that steady growth beyond 1988

13. GDP is equal to GNP less net factor service flows (that is, income earned on factors of production located overseas and owned by U.S. residents less income earned on factors located in this country but owned by non-U.S. residents).

TABLE I-7. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1989 THROUGH 1992

	Actual	Forecast		Projected			
	1986	1987	1988	1989	1990	1991	1992
Nominal GNP (billions of dollars)	4,235	4,486	4,797	5,119	5,469	5,843	6,243
Nominal GNP (percent change)	5.6	5.9	6.9	6.7	6.8	6.8	6.8
Real GNP (percent change)	2.9	2.6	2.7	2.6	2.7	2.7	2.7
Implicit GNP Deflator (percent change)	2.6	3.3	4.1	4.0	4.0	4.0	4.0
CPI-W (percent change)	1.6	3.8	5.2	4.8	4.4	4.4	4.4
Unemployment Rate (percent)	7.0	6.3	6.1	6.0	5.9	5.8	5.7
Three-Month Treasury Bill Rate (percent)	6.0	5.9	6.6	5.8	5.7	5.7	5.7
Ten-Year Government Bond Rate (percent)	7.7	8.1	8.5	7.8	7.4	7.1	6.8
Corporate Profits (percent of GNP)	6.7	6.6	6.6	6.7	6.7	6.8	6.7
Wage and Salary Disbursements (percent of GNP)	49.3	49.3	49.2	49.2	49.3	49.3	49.4
Other Taxable Income (percent of GNP)	20.9	21.2	21.0	20.8	20.6	20.4	20.2

SOURCE: Congressional Budget Office.

TABLE I-8. MEDIUM-TERM ECONOMIC PROJECTIONS FOR FISCAL YEARS 1989 THROUGH 1992

	Actual	Forecast		Projected			
	1986	1987	1988	1989	1990	1991	1992
Nominal GNP (billions of dollars)	4,189	4,409	4,718	5,035	5,380	5,747	6,141
Nominal GNP (percent change)	6.1	5.2	7.0	6.7	6.8	6.8	6.8
Real GNP (percent change)	3.2	2.4	2.8	2.6	2.7	2.7	2.7
Implicit GNP Deflator (percent change)	2.8	2.8	4.1	4.1	4.0	4.0	4.0
CPI-W (percent change)	2.1	2.7	5.1	5.0	4.4	4.4	4.4
Unemployment Rate (percent)	7.0	6.5	6.1	6.0	5.9	5.8	5.8
Three-Month Treasury Bill Rate (percent)	6.4	5.6	6.6	5.9	5.7	5.7	5.7
Ten-Year Government Bond Rate (percent)	8.3	7.8	8.5	8.0	7.5	7.2	6.9
Corporate Profits (percent of GNP)	6.8	6.6	6.5	6.7	6.7	6.8	6.8
Wage and Salary Disbursements (percent of GNP)	49.3	49.4	49.2	49.2	49.3	49.3	49.4
Other Taxable Income (percent of GNP)	20.8	21.0	21.1	20.9	20.7	20.4	20.2

SOURCE: Congressional Budget Office.

would narrow the gap between actual GDP and CBO's estimate of potential GDP (see Appendix B), until the gap reached its historical average value of 0.5 percent in 1992. This path implies that real GDP grows at an annual rate of 2.8 percent from the end of 1988 through the end of 1992. Chiefly because the United States is projected to continue increasing its foreign indebtedness, albeit at a slower rate than in the recent past, net income earned abroad by U.S. residents declines throughout the 1989-1992 period. Thus, average real GNP growth is lower than real GDP growth over the period--2.7 percent compared with 2.8 percent.

Prices and Interest Rates. The 4.0 percent per year projection of growth in the GNP deflator is slightly below its postwar average and appears to be consistent with current underlying price trends. Unlike the GNP deflator, the CPI-W contains the prices of imported goods and, given the projected trend decline in the foreign exchange value of the dollar, rises more rapidly than the GNP deflator--at 4.4 percent per year.

Interest rates were determined by assuming that the rate on 91-day Treasury bills after adjusting for CPI inflation would revert to 1.3 percent, which is approximately its average value since the Korean War. 14/ In turn, it was assumed that, by 1992, the yield spread between the bill rate and the 10-year bond rate would also revert to the average level that prevailed over the same period. This level implies a decline in the long rate over the projection horizon.

---

14. This calculation used a CPI series constructed by CBO that attempts to adjust the published series for changes in the treatment of homeownership costs.

CHAPTER II

THE BUDGET OUTLOOK

The federal deficit in the fiscal year that ends September 30 will be about $157 billion--more than $60 billion below last year's record-breaking level. But the good news is short-lived. If current taxing and spending policies continue unchanged, the deficit will reach $183 billion in 1988 and $192 billion in 1989 before finally declining.

The estimated deficit jumps after 1987 because special factors that reduce this year's deficit will not persist. The deficit improvement this year is less impressive than it first appears since it reflects a first-year bonus from tax reform, as well as the sale of federal government assets and other one-time savings. But tax reform raises the deficit in 1988 and 1989 compared with prior law, and one-time outlay savings fade. Adjusted for these special factors, the deficit would fall steadily as a percent of gross national product (GNP) from 1987 through 1992. The deficit's decline as a share of GNP, however, is more gradual than in earlier estimates.

In June, the Congress approved a blueprint for reducing the deficit for the next three years. The Congressional budget resolution--if fully implemented (as is assumed in the economic forecast described in Chapter I)--would reduce the deficit to $146 billion in 1988, with further reductions in later years. To achieve these savings, the Congress will consider a package of revenue increases and spending reductions this fall.

Even with the policies of the Congressional budget resolution, the deficit remains stubbornly above the targets in the Balanced Budget Act. Two years ago the act set a deficit target of $108 billion in fiscal year 1988. Before recessing in early August, the Congress debated but did not enact any of several competing proposals to amend the Balanced Budget Act's targets and enforcement provisions. On August 20, the Congressional Budget Office and the Office of Management and Budget (OMB) will jointly estimate the extent of across-the-board reductions in spending that would be needed to reach the original $108 billion target. This chapter previews CBO's contribution to the joint report. The Congress is set to resume work on changes to the Balanced Budget Act upon returning in September.

Because most attention now focuses on the fiscal year 1987 outcome and 1988 budget choices, this chapter first discusses the short-run outlook in some detail. Later sections describe the five-year budget outlook under current taxing and spending policies, explaining in particular why the deficit outlook deteriorates after 1987. This discussion also illuminates how tax reform and various one-time outlay savings cause projected deficits to fluctuate from one year to the next. The Congressional budget resolution's strategy for reducing deficits through revenue increases and spending cuts is then described. The chapter concludes by depicting the budget outlook in terms of the National Income and Product Accounts used by most economists for macroeconomic analysis and forecasting.

THE SHORT-RUN BUDGET OUTLOOK

Last February, CBO projected that the federal deficit for fiscal year 1987 would reach $176 billion. The estimates of many private analysts were even higher. All of these estimates, however, were wrong. With most of the fiscal year over, the deficit appears likely to be $18 billion below CBO's earlier projection. The major explanation is higher-than-projected receipts; outlays are very close to the earlier estimates. But the improvement in the deficit does not persist into fiscal year 1988.

1987 Budget Estimates

In fiscal year 1987, federal government outlays will exceed $1 trillion for the first time. Total spending will reach about $1,010 billion--an increase of only 2 percent over 1986. But the slightly higher spending is more than offset by higher revenues. Fiscal year 1987 revenues should reach about $853 billion, an increase of 11 percent over 1986. The resulting deficit is about $157 billion (see Table II-1).

Higher individual income taxes contribute most to 1987's strong revenue growth. The Tax Reform Act of 1986 was expected to boost revenues in the first year, because many taxpayers would realize capital gains before a rate increase took effect. But the tax estimators underpredicted the bonus. As a result, greater-than-expected taxes flowed into the Treasury in early 1987. Nonwage incomes have also been stronger than projected, boosting income taxes. Finally, withheld income taxes in 1987 consistently exceeded earlier estimates. Millions of wage and salary earners apparently chose to maintain the same relative overwithholding on their newly reduced liabilities as they filled out forms mandated by the Tax Reform Act, contrary to earlier assumptions that overwithholding would be reduced.

The revenue news in 1987 is not uniformly positive: corporate income taxes will fall $15 billion short of earlier estimates. Part of the shortfall stems from lower-than-projected profits. Nearly all of the rest comes from a smaller net gain from tax reform, reflecting smaller gains from repealing the investment tax credit and greater losses from depreciation provisions.

Previous estimates of federal government spending in 1987, which were described in detail in reports published last winter, need little revision. Enacted legislation (mainly a supplemental appropriation bill) adds $3 billion to outlays. Higher interest rates add about $1 billion but are largely offset by lower unemployment insurance outlays and valuation gains on the government's foreign exchange holdings. Technical reestimates reduce outlays for farm price supports, deposit insurance, and Social Security more than enough to offset scattered spending increases. Finally, changing the budgetary treatment of the new thrift fund for federal employees--as recommended by the General Accounting Office--raises 1987 outlays by $1 billion.

The Budget Outlook for 1988

In contrast to 1987, the deficit outlook for fiscal year 1988 has deteriorated. The most recent estimates for fiscal year 1988 highlight the

TABLE II-1. THE OUTLOOK FOR FISCAL YEARS 1987 AND 1988
(In billions of dollars)

		1988		
	1987 Estimate	CBO Baseline Projection	Base for Balanced Budget Act	Budget Resolution Policies
Total (Including Social Security)				
Outlays	1,010	1,080	1,067	1,064
Revenues	853	897	897	918
Deficit	157	183	170	146

SOURCE: Congressional Budget Office.